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Supreme Court to Hear Key Case on Loss Causation in Securities Fraud Claims

The United States Supreme Court recently granted the petition for certiorari filed by defendants in *Dura Pharmaceuticals, Inc. v. Broudo*, a class action securities case, to consider an issue that has divided the courts of appeals – whether a plaintiff in a private securities fraud action must plead and prove that a stock price decline resulted from the alleged misconduct. Resolution of this issue will determine whether plaintiffs can recover (and whether a complaint can be dismissed before costly discovery) where there are no facts suggesting that correction of the alleged misleading statements had a harmful effect on the price of plaintiffs' securities. The Court is expected to address the means by which the key "loss causation" requirement for federal securities fraud claims can be pleaded and proved. In addition, this case may provide a rare opportunity for the Court to consider and comment on the "fraud on the market" doctrine that forms the underpinning for all class action federal securities claims, which the Court adopted in a plurality opinion in *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988).

Causation in Securities Cases

To recover on a claim of securities fraud, plaintiffs must prove that defendant's conduct – typically alleged misleading or incomplete disclosures to the securities markets – caused their injury. The causation inquiry has two distinct components: "transaction causation," and "loss causation."

Transaction causation is the equivalent of traditional cause-in-fact (or "but for" causation). It requires proof that plaintiffs would not have entered into the securities transaction but for the alleged fraud. Transaction causation is akin to the element of reliance in fraud claims. Unlike common law fraud claims, however, where plaintiffs must show they knew about and relied on the specific misrepresentations they allege, in class action securities claims the fraud on the market doctrine allows plaintiffs to satisfy this element with a rebuttable presumption of reliance "on the market" – that is, that the market price they paid for a security fairly reflects accurate and complete corporate disclosures. This presumption is founded on an "efficient capital market hypothesis" that the prices of all securities traded on efficient markets (*i.e.*, well-informed and highly liquid markets) accurately reflect all publicly available information relevant to their valuation. Without this presumption, it is doubtful that securities fraud cases could proceed as class actions because they would require individual proofs of reliance on

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disclosures, which would be inconsistent with the requirement that class action claims be provable by means of representative evidence applicable to all class members. *See generally Basic*, 485 U.S. at 242-49.

Loss causation is analogous to the traditional tort-law element of proximate cause. It permits plaintiffs to recover only losses that were proximately caused by the alleged misleading disclosures. It precludes recovery of losses attributable to other factors – unrelated market-wide or company-specific events that affected prices. This long-standing common law requirement for fraud claims was codified as an element in federal securities fraud claims in the Private Securities Litigation Reform Act of 1995 ("PSLRA"). That statute was passed by Congress in an attempt to curb the filing of factually unsupported securities claims, and make class action securities litigation less lawyer-driven.[1] Concerning loss causation, the PSLRA provides that "the plaintiff shall have the burden of proving that the act or omission of the defendant alleged to violate this chapter caused the loss for which the plaintiff seeks to recover damages." 15 U.S.C. § 78u-4(b)(4).[2]

The Dura Pharmaceuticals Litigation

In February 1998, the stock price of Dura Pharmaceuticals, Inc. ("Dura"), a developer of products for the treatment of allergies, asthma and other respiratory conditions, tumbled following its announcement that it was anticipating lower revenues and earnings for 1998 than previously forecasted. The stock price dropped once again in November 1998, when Dura announced that the FDA had decided not to approve Albuterol Spiros, its new delivery device for asthma drugs. This time, however, the stock price bounced back, returning to its previous level within twelve trading days. Nevertheless, several Dura shareholders filed a class action federal securities fraud lawsuit against the company and some of its officials in California, alleging that false statements about Albuterol Spiros and other aspects of Dura's business inflated the market price of Dura stock. Plaintiffs filed the claim on behalf of a class of purchasers of Dura shares between April 15, 1997 and February 24, 1998, the date Dura announced its lower earnings expectations, not the date Dura announced non-approval of Albuterol Spiros by the FDA.[3]

Defendants moved to dismiss the complaint on a number of grounds, including that, as to the Albuterol Spiros allegations, the complaint failed to allege facts showing loss causation – that disclosures or omissions relating to Albuterol Spiros caused any loss. The district court agreed and dismissed the complaint because it failed to show any relationship between the problems with Albuterol Spiros and the February stock price drop.[4] The court noted that the February 24 announcement did not "contain[] any negative information about Albuterol Spiros" and it was not until November (nine months later), that Dura announced the FDA non-approval. *In re Dura Pharms., Inc. Sec. Litig.*,

[1] *See* S. Rep. No 104-98, at 6, 10 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 685, 689.

[2] The statute refers only to "proving" loss causation, raising the issue whether the PSLRA contemplates applying this standard at the pleadings stage, and if so, how particularized those allegations must be. *See, e.g. In re Initial Public Offering Sec. Litig.*, 241 F. Supp. 2d 281, 372 (S.D.N.Y. 2003). The House-Senate Conference Report accompanying the PSLRA states that the PSLRA requires a plaintiff "*to plead* and then to prove that the misstatement or omission alleged in the complaint actually caused the loss incurred.…" Conference Rep. (H. Rep. No. 104-369), at 41 (1995) (emphasis added).

[3] Plaintiffs presumably decided not to choose the November announcement as the end of the class period because of the PSLRA's so-called "look back" provision, which limits plaintiff's damages to the difference between the purchase price and the mean trading price of the stock during the 90 day period following the correction of the misstatement. *See* 15 U.S.C. §78u-4(e)(1). In effect, this provision limits (or eliminates) damages where the stock price "bounces back" after a corrective disclosure.

[4] The district court also held that the complaint failed to plead scienter (intent or recklessness) as to allegations regarding one of Dura's other products, Ceclor CD.

No. 99cv0151-L(NLS), *slip op.* at 15 (S.D. Cal. Nov. 2, 2001).

The Ninth Circuit reversed,[5] holding that plaintiffs were not required to allege a relationship between the problems with Albuterol Spiros and the February drop in stock price. *Broudo v. Dura Pharmaceuticals, Inc.*, 339 F.3d 933 (9th Cir. 2003). The court reasoned that plaintiffs incurred their injury when they paid more for the stock than its true value because its price was artificially inflated by the alleged fraud. As a result, in the Ninth Circuit, "loss causation does not require pleading a stock price drop following a corrective disclosure. It merely required pleading that the price at the time of purchase was overstated and sufficient identification of the cause." *Id.* at 938. Plaintiffs' complaint did include a general allegation of this nature.

Split in the Circuits

The federal courts of appeals are divided on how to apply the loss causation requirement to federal securities claims. Several Circuits, including the Second, Third, Seventh and Eleventh, favor a "market price" approach, under which plaintiffs must plead (and eventually prove) a direct causal connection between the alleged misleading statements and changes in market price of the securities.[6] These courts find it insufficient for plaintiffs to allege only that the stock price was artificially inflated by the alleged misleading disclosures where there is no loss in value of the securities held by plaintiffs attributable to corrective disclosure, on the theory that investors are not harmed if their securities did not lose value because the alleged fraud was discovered. For example, in *Robbins v. Kroger Properties, Inc.*, investors sued Kroger Properties, Inc. ("KPI"), its officers, and its auditor when the stock price dropped following a dividend cut, alleging that KPI's financial statements fraudulently overstated cash flow. At trial on the claims against the auditor, plaintiffs presented evidence that the auditor made fraudulent statements that inflated the stock price, but the evidence showed that the dividend cut was announced (and the stock price decline complained of by plaintiffs occurred) more than a year before the alleged accounting fraud was uncovered, and that the Board of Directors cut the dividend for reasons unrelated to the alleged fraud. The trial court denied the auditor's motion for judgment as a matter of law, and the jury found for plaintiffs. The Eleventh Circuit reversed, holding that plaintiffs did not satisfy the loss causation requirement because there was "no evidence that this price inflation [from the accounting fraud] was removed from the market price of KPI stock, causing plaintiffs a loss." *Robbins*, 116 F.3d at 1448.

In contrast, the Eighth and Ninth Circuits have held that a plaintiff can plead a securities fraud claim based on alleged misleading disclosures even without any apparently related market price impact of corrective disclosures as long as they allege an impact on market price at the time they purchased the security.[7] These cases allow claims to proceed on the basis of general allegations of harmful price impact related to alleged misleading disclosures, which presumably will be proved not by showing an actual market price effect but through "expert" proof that the misleading disclosures should have impacted market price and caused plaintiffs to purchase securities that were worth less than what plaintiffs paid.

The Government Weighs In

At the request of the Supreme Court, the United States Solicitor General filed a brief stating the Government's views on the petition for certiorari

[5] The Ninth Circuit also remanded for further proceedings on the scienter issue.

[6] *See Emergent Capital Inv. Mgmt., LLC v. Stonepath Group, Inc.*, 343 F.3d 189 (2d Cir. 2003); *Semerenko v. Cendant Corp.*, 223 F. 3d 165 (3d Cir. 2000); *Bastian v. Petren Res. Corp.*, 892 F.2d 680 (7th Cir. 1990); *Roots P'Ship v. Lands End, Inc.*, 965 F.2d 1411 (7th Cir. 1992); *Robbins v. Kroger Props., Inc.*, 116 F.3d 1441 (11th Cir. 1997).

[7] *See Gebhardt v. ConAgra Foods, Inc.*, 335 F.3d 824 (8th Cir. 2003); *Dura*, 339 F.3d 933.

in *Dura*. The Government's brief, which was also signed by the General Counsel and Solicitor of the Securities and Exchange Commission, supported grant of the writ. It noted the Circuit split and the importance of the issue in securities cases, argued that the Ninth Circuit's approach was incorrect, and favored the "market price" approach.[8] The Government found two particular flaws in the Ninth Circuit's reasoning. First, it questioned the theory that plaintiffs suffered a loss at the time of purchase regardless of any later impact (or no later impact) on market price. The Government argued that until a stock's artificial price inflation is reduced or eliminated, an investor who overpaid could recoup some or all of his overpayment by reselling the stock at the inflated price. Measuring loss at the time of purchase would result in a windfall for investors who never realized an actual loss, or perhaps realized a lesser loss.[9] Second, the Government argued that the Ninth Circuit's decision conflated the distinct requirements of transaction causation and loss causation. In a fraud on the market case like *Dura*, transaction causation is satisfied by the presumption that a material misrepresentation or omission impacted the market price of the security, which plaintiffs mistakenly believed was a "true value." The Ninth Circuit's holding essentially permits such a claim without any need to show loss causation because proof of a material misrepresentation and an efficient market would satisfy both the transaction and loss causation requirements, a "result [that] is difficult to reconcile with the well-established principle that transaction causation and loss causation are distinct elements of a Rule 10b-5 cause of action."

Implications of the Loss Causation Standard

The standards for pleading and proving loss causation are of particular importance in the current securities litigation environment. Stock prices have been highly volatile in recent years. Aggressive stock valuations can result in severe losses whenever "bad news" is disclosed, and potential class action plaintiffs and their counsel will search for theories by which losses can be attributed to misleading disclosures (rather than unexpected negative developments). The loss causation requirement is the element of a securities fraud action that should filter out claims by investors seeking "insurance" for losses caused by unpredictable developments and market fluctuations (the inevitable risk for investors seeking high rewards) from those where improper disclosures can be factually linked to the decline in securities' prices.[10] By allowing claims to proceed without any apparent factual link between a market price decline and the alleged fraud, the Ninth Circuit rule moves in the direction of making securities issuers (and their officers and directors) insurers against stock price declines. This rule lowers the gateway for plaintiffs to commence extensive and costly litigation that could come down to a jury's evaluation of a "battle of experts" over the theoretical impact of alleged false disclosures on a security's price even where there was no demonstrable actual impact on price. As a practical matter, because the modern era of high stock volume raises many of these cases to "bet the company" levels, expensive settlements are the likely recourse of defendants. It was exactly that scenario that led Congress to

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[8] The Government also took the position, however, that an investor can suffer a loss without a decline in stock price "because the inflation attributable to fraud could be reduced or eliminated even if there were a net increase in price. That could happen, for example, if the company corrected the false information and at the same time issued unrelated positive information."

[9] A recent working paper released by NERA Economic Consulting discusses how the "price inflation" and "price decline" approaches to loss causation can result in different damages calculations. *See* David Tabak, *Loss Causation and Damages in Shareholder Class Actions: When It Takes Two Steps To Tango* (May 2004) (available at www.nera.com).

[10] *See Bastian*, 892 F.2d at 683-86 (affirming dismissal where plaintiffs failed to plead that their loss was caused by defendants' conduct and not general collapse of oil and gas limited partnerships); *Miller v. New Am. High Income Fund*, 755 F. Supp. 1099, 1107-09 (D. Mass. 1991) (dismissing complaint where plaintiffs alleged that collapse of high-yield bond market caused their loss).

establish more stringent pleading requirements for securities fraud cases in the PSLRA. That drama is now being replayed in the context of pleading and proof of injury.

Implications for the Fraud on the Market Theory

One implication of the approach to loss causation endorsed by the Ninth Circuit in *Dura* is that it may permit plaintiffs to plead loss causation even when corrective disclosures do not affect the market price of securities, and there is no apparent explanation other than that the information was not important to "the market." This result is troubling, because it appears to permit use of the fraud on the market doctrine (and its foundation, the efficient capital market hypothesis) to presume the reliance element and allow class action claims to proceed, but ignores the same principles with regard to the merits of other key elements of a securities fraud claim: transaction causation, loss causation, and materiality.[11]

One example of this inconsistent treatment of the fraud on the market doctrine is a Ninth Circuit case that preceded *Dura*: *No. 84 Employer-Teamster Joint Council Pension Trust Fund v. America West Holdings Corp.*, 320 F.3d 920 (9th Cir. 2003). The district court in *America West* dismissed plaintiffs' claims on materiality grounds because corrective disclosures addressing the alleged fraud (relating to regulatory violations alleged by the FAA) caused no market response. The only identifiable stock price drop occurred two months later upon disclosure of an earnings shortfall with no apparent connection to the FAA matters. A divided panel of the Ninth Circuit reversed, holding that because "[t]he market is subject to distortions that prevent the ideal of 'a free and open public market' from occurring," plaintiffs could still pursue their case.[12] Indeed, the Ninth Circuit opinion expressly accepted that the fraud on the market theory may apply for purposes of proving reliance but not in relation to other elements of the claim. 320 F.3d at 934 n.12. And, it did so based on language in the Supreme Court's decision in *Basic* that it did not "intend conclusively to adopt any particular theory of how quickly and completely publicly available information is reflected in the market price." 485 U.S. at 248 n.28.[13]

Although the issue before the Supreme Court is how a plaintiff must plead and prove loss causation, the interconnection between the fraud on the market theory and loss causation may prompt some Justices to address the contours of the fraud on the market theory. This is a rare opportunity for the Court to address this seminal issue, and it may be difficult for the Justices to resist comment in view

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[11] Some courts have held that the absence of market price response to corrective disclosures effectively precludes claims because it shows not reliance, but *lack of* reliance by the market on the disclosures that form the basis for the claims. *See Nathenson v. Zonagen Inc.*, 267 F.3d 400, 415-17 (5th Cir. 2001) (because lack of market reaction to corrective disclosure undercuts reliance element in fraud on the market case, "where the facts…reflect that the information in question did not affect the price of the stock then the district court may properly deny fraud-on-the-market based recovery"). Moreover, in a fraud on the market case, loss causation and materiality are closely linked. Information that is significant enough to be deemed material should, by definition, be significant enough to alter market price (all other things being equal). Thus, courts have also held that the market's lack of reaction to a corrective disclosure means the disclosure, and the alleged fraud related to the disclosure, were immaterial as a matter of law. *See Oran v. Stafford*, 226 F.3d 275, 282 (3d Cir. 2000) ("if a company's disclosure of information has no effect on stock prices, 'it follows that the information disclosed…was immaterial as a matter of law'" (citation omitted)).

[12] A case along similar lines is the Eighth Circuit's decision in *Gebhardt*, 335 F.3d 824. The issuer in that case, ConAgra Foods, Inc., announced a restatement of its financial statements to correct relatively small accounting errors at one of its subsidiaries. ConAgra's stock price did not react appreciably when the restatement was announced. The district court dismissed the complaint for failure to plead both transaction and loss causation, but the Eighth Circuit reversed, accepting plaintiffs' argument that it should be permitted to attempt to prove its general allegation that stock prices had been impacted by the errors even if there was no apparent impact following ConAgra's corrective disclosure.

[13] The dissenting judge in *America West* noted that this approach placed the Ninth Circuit in direct conflict with the Third Circuit in *Oran*, 226 F.3d at 282, and the Fifth Circuit in *Zonagen*, 320 F.3d at 947-49.

of the significance of the fraud on the market theory to securities class actions, the fact that a majority of the Court never agreed on the theory or what it means, the lower courts' apparently inconsistent application of the doctrine,[14] and recent scholarly writings inquiring into the viability of the underlying efficient markets hypothesis.[15] Any guidance could be of considerable importance in future cases, as the federal courts are currently struggling with the application of the fraud on the market theory in the context of highly volatile markets, more aggressive theories of materiality, and non-traditional fact patterns being pursued by plaintiffs' lawyers.[16]

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14 *See, e.g.,* Geoffrey C. Rapp, *Proving Markets Inefficient: The Variability of Federal Court Decisions on Market Efficiency in* Cammer v. Bloom *and its Progeny*, 10 U. Miami Bus. L. Rev. 303 (2002); Jeffrey L. Oldham, Comment, "*Taking 'Efficient Markets' Out of the Fraud-on-the Market Doctrine After the Private Securities Litigation Reform Act*," 97 Nw. U. L. Rev. 995 (2003); Matthew M. Sanderson, Comment, "*A 'Basic' Misunderstanding: How the United States Supreme Court Misunderstands Capital Markets*," 43 S. Tex. L. Rev. 743 (2003).

15 *See, e.g.,* P. Ferrillo, F. Dunbar & D. Tabak, *The "Less Than" Efficient Capital Markets Hypothesis: Requiring More Proof from Plaintiffs in Fraud-on-the-Market Cases*, 78 St. John's L. Rev. 81 (2004); D. Langevoort, *Theories, Assumptions, and Securities Regulation: Market Efficiency Revisited*, 140 U. Penn. L. Rev. 851 (1992); J. Macey, G. Miller, M. Mitchell, & J. Netter, *Lessons from Financial Economics: Materiality, Reliance, and Extending the Reach of* Basic v. Levinson, 77 Vir. L. Rev. 1017 (1991); J. Macey & G. Miller, *Good Finance, Bad Economics: An Analysis of the Fraud-on- the-Market Theory*, 42 Stan. L. Rev. 1059 (1990).

16 *See, e.g., Hevesi v. Citigroup Inc.,* 366 F.3d 70, 80 (2d Cir. 2004) (allowing interlocutory appeal of class certification order applying the fraud on the market theory to statements made by research analysts).